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TAGS: EFIN PGOV PINR VE
SUBJECT: BRV CONTINUS TO FIGHT EXCESS LIQUIDITY

REF: CARACAS 003601

This message is sensitive but unclassified, pleae treat accordingly.

Summary

¶1. (SBU) The BRV continues to struggle with rapidly increasing money supply resulting from xpansionary fiscal policy, booming oil revenues, and foreign exchange restrictions. The money suply (M2) increased by 52.7 percent in 2005 and ha grown approximately 260 percent since the BRV iplemented its foreign exchange restrictions in Fbruary 2003. The amount of excess liquidity in the system comes to around USD 14.5 billion (roughlyestimated as total Central Bank-issued CDs plus he amount of banking system reserves held in excss of the legal reserve requirement). This exces liquidity is already pushing down interest rates, and, if left unchecked, will intensify inflationay pressure and threaten the country's over-value fixed exchange rate. The BRV has been actively ighting its liquidity problem by issuing certifiates of deposit and dollar-denominated bonds, purchasing and reselling foreign bonds, authorizing moe foreign currency transactions, and increasing bank reserve requirements. While all of these moves help to ease the glut of bolivars in circulation, the liquidity problem will not go away anytime soon, as oil revenues continue to flood in and the BRV continues its profligate spending in the run-up to the December presidential elections. End summary.

¶2. (U) While the Venezuelan economy continues to boom on the back of high oil prices, the Venezuelan Central Bank (BCV) has been dealing with a serious problem of excess liquidity. The combination of continued high oil revenues, an extremely loose fiscal policy stance, and foreign exchange controls have created distortions in the market and steady increases in the money supply. As measured by the M2 monetary aggregate, the money supply is currently around USD 32.6 billion, an increase of 52.7 percentduring 2005 and around 260 percent since the BRVimplemented foreign exchange restrictions in Febuary 2003. Of this amount, analysts estimate abut USD 14.5 billion to be excess liquidity. (Note: Excess liquidity is roughly estimated here as totl Central Bank-issued CDs plus the amount of baning system reserves held in excess of the legal reserve requirement.

End Note.)

¶3. (U) If left unchecked, this excess liquidity could be a real problem for the BRV (and perhaps some banks), causing strong inflationary pressures and threatening the integrity of the over-valued fixed exchange rate, which is currently set at Bs. 2150/USD 1. The excess liquidity has also put downward pressure on interest rates, which has forced the BCV to cut rates on its 28-day bill by 150 basis points to 10 percent. (Note: Currently, real interest rates, or the interest rate adjusted for inflation, are negative. When real interest rates are negative, consumers have no incentive to save, rather only to spend as evidenced by increasing consumer spending, exacerbating the expansion of the money supply. End Note.) As a result, the BRV, through the Central Bank (BCV), the Ministry of Finance (MF) and the Foreign Exchange Control Commission (CADIVI), has been aggressively combating the problem by implementing several types of measures, including the issuance of domestic certificates of deposit and dollar-denominated bonds, the purchase and resale of foreign bonds, increased foreign currency disbursements, and an increase in the bank reserve requirements.

Central Bank

¶4. (U) The Central Bank (BCV) has used two primary methods for fighting liquidity: issuing certificates of deposit to absorb excess liquidity and increasing the bank reserve requirement to slow bank lending. The BCV currently issues CDs for 14, 21 and 28 days and now has over USD 14 billion outstanding. The negative effect from issuing these CDs is that the BCV has to continually recycle this paper in order to keep liquidity down. Also, interest paid domestically on these notes (in dollar terms around USD 871 million in 2005) has a snowballing effect as it serves to further increase the money supply.

¶5. (U) Another method used by the BCV to combat the growing liquidity is to increase the bank reserve requirements. The BCV recently announced that by March 6, commercial banks will be required to reserve 5 percent of their money market holdings. This reserve requirement will then increase by 0.5 percent every four weeks until it reaches 15 percent, the current reserve requirement for demand deposits. Increasing the reserve requirement on money market funds requires the banks to hold cash instead of investing it, and effectively limits the exponential increase in money supply caused by bank lending. While this increase will help to reduce the money supply, it will also have the negative effect of reducing bank profits by limiting the amount of capital available to invest.

Ministry of Finance

¶6. (U) While the Ministry of Finance is not responsible for monetary policy, their actions have helped to complement the policy of the BCV. The Ministry of Finance has issued dollar-denominated domestic bonds as well as purchased foreign bonds, both of which have helped to reduce liquidity. In November 2005, the BRV issued USD 3.0 billion in dollar-denominated domestic bonds with the intent of soaking up some of the excess liquidity in the market (reftel). Because the BRV allowed investors to purchase the bonds in bolivars, the instrument became an effective mechanism to bypass the foreign exchange controls and obtain dollars, reducing the glut of bolivars. While the issue had the intended effect (reducing excess liquidity by roughly 21 percent), it also substantially increased the total debt of the BRV.

¶7. (U) The Ministry of Finance has also purchased bonds from other countries, primarily Argentina, which have helped to reduce liquidity. Over the past year, the BRV has purchased approximately USD 2.1 billion in Argentine bonds. As with the domestic bonds, the BRV resells these

dollar-denominated bonds to domestic investors (in some cases hand-picked by the BRV) for bolivars. These investors can then resell the bonds for dollars and turn a quick and very lucrative profit. Purchasing the Argentine bonds has the benefit of reducing liquidity while not increasing the debt burden. The primary reason for their purchase, however, is that they have allowed Chavez to gain political points by becoming one of Argentina's major benefactors.

CADIVI

¶8. (U) In addition the BCV and the MF, the National Exchange Control Administration (CADIVI) has also been instrumental in keeping the money supply down. CADIVI is the agency charged with authorizing foreign exchange transactions and, in an effort to fight inflation and protect the fixed exchange rate it has increased the amount of transactions. During 2005, the BCV disbursed (following CADIVI authorization) USD 19.43 billion in foreign exchange (an increase of 31 percent from 2004) effectively reducing liquidity by an equivalent amount.

Comment

¶9. (SBU) The methods employed by the BCV have been effective in reducing monetary liquidity. However, this problem will not go away anytime soon. High oil prices are still flooding the market with cash and the BRV is continuing its profligate spending on social programs (and can be expected to do so at least until the December presidential elections). The high oil revenues and increased government spending are driving the extraordinary real GDP growth we currently see (9.4 percent in 2005, and an expected 6-7 percent in 2006), and, for the short-term, there is no threat of hyperinflation. However, these pro-cyclical policies are unsustainable in the medium-term and will undoubtedly exacerbate the eventual downturn that occurs when oil prices ease.

WHITAKER